INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statutes and regulations involved	3
Statement	3
Argument	6
Conclusion	14
Appendix	15

CITATIONS

Cases:

Baker v. *Commissioner*, 80 F. (2d) 813	7
Bogardus v. *Commissioner*, 302 U. S. 34	10
Bondholders' Committee v. *Commissioner*, 315 U. S. 189	8
Burdick v. *Commissioner*, 76 F. (2d) 672	14
Commissioner v. *Babson*, 70 F. (2d) 304, certiorari denied, 293 U. S. 571	9
Commissioner v. *Brown*, 69 F. (2d) 602	10
Commissioner v. *Champion*, 78 F. (2d) 513	8
Commissioner v. *Cordingley*, 78 F. (2d) 118	10
Commissioner v. *Quackenbos*, 78 F. (2d) 156	10
Commissioner v. *Rockwood*, 82 F. (2d) 359	10
Faris v. *Helvering*, 71 F. (2d) 640, certiorari denied, 293 U. S. 584	7
Flanagan v. *Helvering*, 116 F. (2d) 937	11
Goldstein v. *Commissioner*, 113 F. (2d) 363	9
Helvering v. *Gowran*, 302 U. S. 238	8
Helvering v. *Tex-Penn Co.*, 300 U. S. 481	10
Hirsch v. *Commissioner*, 124 F. (2d) 24	9, 13
Hyman v. *Helvering*, 71 F. (2d) 342, certiorari denied, 293 U. S. 570	9
Leland v. *Commissioner*, 50 F. (2d) 523, certiorari denied, 284 U. S. 656	6
Le Tulle v. *Scofield*, 308 U. S. 415	8
Lincoln Nat. Bank v. *Burnet*, 63 F. (2d) 131	13
Merchants' L. & T. Co. v. *Smietanka*, 255 U. S. 509	14
Patty v. *Helvering*, 98 F. (2d) 717	10, 11
United States v. *Wells*, 283 U. S. 102	10

475703—42——1

Statute: Page

Revenue Act of 1926, c. 27, 44 Stat. 9, sec. 201 12
Revenue Act of 1926, c. 852, 45 Stat. 791, sec. 115 12
Revenue Act of 1932, c. 209, 47 Stat. 169, sec. 1 12
Revenue Act of 1934, c. 277, 48 Stat. 680:
Sec. 1 12
Sec. 115 15

Miscellaneous:

H. Rep. No. 1, 69th Cong., 1st Sess., p. 5 (1939–1 Cum. Bull. (Part 2) 315, 318) 8
H. Rep. No. 356, 69th Cong., 1st Sess., p. 30 (1939–1 Cum. Bull. (Part 2) 361) 8
H. Rep. No. 708, 72d Cong., 1st Sess., p. 22 (1939–1 Cum. Bull. (Part 2) 457, 473) 12
S. Rep. No. 52, 69th Cong., 1st Sess., p. 15 (1939–1 Cum. Bull. (Part 2) 332, 344) 7, 12
S. Rep. No. 665, 72d Cong., 1st Sess., p. 31 (1939–1 Cum. Bull. (Part 2) 496, 518) 12
S. M. 4241, IV–2 Cum. Bull. 191 14
Treasury Regulations 86:
Art. 115–1 ..... 8, 16
Art. 115–2 ..... 8, 16
Art. 115–5 ..... 8, 17
Art. 115–9 ..... 8, 17

In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 239

JAMES A. RHEINSTROM, EXECUTOR UNDER THE WILL OF MINNA W. RHEINSTROM, DECEASED, PETITIONER

v.

THOMAS J. CONNER, COLLECTOR OF INTERNAL REVENUE

No. 240

FIRST NATIONAL BANK, CINCINNATI, OHIO, TRUSTEE UNDER THE WILL OF KARL KIEFER, DECEASED, PETITIONER

v.

THOMAS J. CONNER, COLLECTOR OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 60–67) is reported in 33 F. Supp. 917. The opinion of

the Circuit Court of Appeals (R. 94-105) is reported in 125 F. (2d) 790.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on February 13, 1942 (R. 93–94) A petition for rehearing, filed March 14, 1942 (R. 107), was denied on April 17, 1942 (R. 139). The petition for writs of certiorari was filed July 16, 1942. Jurisdiction of this Court is invoked under section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In 1914, a corporation reduced its capital stock by cancelling shares of its common stock *pro rata* between the two holders, and transferring the amount of the reduction, $122,000, from common stock to surplus. This sum was later transferred to a new account designated "paid-in surplus". In 1934 the corporation distributed $122,000 to its stockholders in addition to paying a dividend of $90,000. The company's earnings for 1934 were more than sufficient to pay both distributions.

The question is whether the payment of $122,000 was a distribution in partial liquidation under section 115 (a) and (i) of the Revenue Act of 1932, or whether it was taxable as a dividend under section 115 (a) and (b) or (g) of the act.

STATUTES AND REGULATIONS INVOLVED

The relevant statutes and regulations are set forth in the Appendix, *infra,* pages 15–18.

STATEMENT

These cases involve different taxpayers, but present the same question, arising from the same facts. Separate refund suits were brought in the District Court (R. 1–6, 71–76), and the cases were heard separately. They were submitted together, however, and disposed of by the District Court in combined findings of fact and combined conclusions of law (R. 60–67, 87). Judgments were entered for the Collector (R. 67–68, 88). By stipulation the cases were presented to the Circuit Court of Appeals for review on the same record (R. 89–91); the judgments of the District Court were there affirmed (R. 93–94).

The facts found by the District Court may be summarized as follows (R. 94–96):

The Karl Kiefer Machine Company, an Ohio corporation, was organized in 1908. It had an authorized capital of $500,000, consisting of 3,000 shares of common stock and 2,000 shares of preferred stock, each with a par value of $100 per share. One thousand five hundred shares of common stock and 420 shares of preferred stock were fully paid for, and the total paid-in capital amounted to $192,000. (R. 60–61.) Karl Kiefer and Minna W. Rheinstrom each owned 748 shares

of the common stock (R. 61). The remaining four shares were held in the names of others to qualify them as directors. Kiefer owned all of the outstanding preferred (R. 63).

On November 30, 1914, the directors authorized a reduction of the corporation's authorized capital stock from $500,000 to $70,000. The preferred stock was reduced to $42,000, represented by 420 shares (the amount previously issued), and the common stock was reduced to $28,000, represented by 280 shares. A certificate of reduction of capital stock was filed with the Secretary of State of Ohio, and each of the two principal owners thereupon received new certificates for 138 shares of common in exchange for the original 748 shares. (R. 61.)

This transaction was reflected on the books of the company by reducing the value of the common stock account from $150,000 to $28,000 and transferring the difference of $122,000 to the surplus and undivided profits account, increasing the latter from $31,006.80 to $153,006.80. In 1921 the $122,000 was again transferred to a new account designated as "paid in capital", but no actual distribution of any kind was made, and there was no physical segregation of assets nor any other action taken in regard to the capital stock reduction until 1934. (R 61.) In 1934 the company, in addition to the payment of a dividend of $90,000, disbursed $122,000 to the stockholders and cancelled

the "paid in surplus" account. The payment was designated as one which arose by the reduction of the common stock in 1914. Half of this sum, amounting to $61,000, was distributed to Minna Rheinstrom (whose executor is the petitioner in No. 239), and the other half to the beneficiaries under the will of Karl Kiefer (including the petitioner in No. 240). (R. 61–62.)

The corporation's earnings for the year 1934 were more than sufficient to pay the $90,000 dividend and the $122,000 (R. 62). Assessments were made against the taxpayers on the theory that the distribution of the $122,000 was a taxable dividend.

The District Court rejected the contention of the taxpayers that the distribution was a partial liquidation under section 115 (c) and (i) of the Revenue Act of 1934. The court appears to have proceeded on the theory that the reduction of the stock in 1914 and the distribution in 1934 were separate transactions. It concluded that under section 115 (b) the 1934 distribution must be presumed to have been made from available earnings, and accordingly that the distribution was a dividend under section 115 (a).

The Circuit Court of Appeals concluded that the evidence sustained the finding that the distribution was a taxable dividend (R. 105). Proceeding upon the assumption that the distribution was made in a cancellation of the common stock, the

court held that it was "essentially equivalent to the distribution of a taxable dividend" within the meaning of section 115 (g) of the act and therefore properly taxable as such.

ARGUMENT

1. In the disposition of this case, it is immaterial whether the theory of the Circuit Court of Appeals or that of the District Court is adopted; for whether the distribution in 1934 was made in cancellation or redemption of the common stock, or not, a decision that the funds are taxable as a dividend follows from the facts found by the court below.

If the 1934 distribution was a transaction separate from the reduction in the corporation's capital stock 20 years before, as the District Court appears to have regarded it, the decisive issue is whether earnings were distributed within the meaning of section 115 (a). The corporation had current earnings in 1934 in excess of the amount of the distribution, and section 115 (b) establishes a conclusive presumption that "every distribution is made out of earnings or profits to the extent thereof, and from the most recent accumulated earnings or profits." Accordingly, irrespective of the designation given to the distribution by the parties, there was a distribution of earnings and hence a dividend within the plain meaning of the statute and the settled course of authority. *Leland* v. *Commissioner,* 50 F. (2d)

523 (C. C. A. 1), certiorari denied, 284 U. S. 656; *Baker* v. *Commissioner,* 80 F. (2d) 813, 815 (C. C. A. 2); *Faris* v. *Helvering,* 71 F. (2d) 610 (C. C. A. 9), certiorari denied, 293 U. S. 584.

The Circuit Court of Appeals approached the problem upon the alternative theory that the distribution in 1934 was made in cancellation or redemption of the common stock. In this posture of the case, the distribution was precisely the kind which section 115 (g) is designed to tax as a taxable dividend. The situation here was almost identical with the example given in the committee reports accompanying the Revenue Act of 1926, in which the provisions of section 115 (g) were first adopted as section 201 (g) thereof. The report of the Senate Committee on Finance stated (S. Rep. No. 52, 69th Cong., 1st Sess., p. 15 (1939–1 Cum. Bull. (Part 2) 332, 344)):

> Section 201 (g): It has been contended that under existing law a corporation, especially one which has only a few stockholders, might, without resorting to the device of a stock dividend, be able to make a distribution to its stockholders which would have the same effect as a taxable dividend. For example: Assume that two men hold practically all the stock in a corporation, for which each had paid $50,000 in cash, and the corporation had accumulated a surplus of $50,000 above its cash capital. It is claimed that under existing law the corporation could buy from the stockholders,

> for cash, one-half of the stock held by them and cancel it without making the stockholders subject to any tax. Yet this action, in all essentials, would be the equivalent of a distribution through cash dividends of the earned surplus. The subdivision as rewritten by the House bill is intended to make clear that such a transaction is taxable and the committee approves the provision, which obviously does not apply in cases of complete liquidation of all the stock of the corporation.

See also H. Rep. No. 1, 69th Cong., 1st Sess., p. 5 (1939–1 Cum. Bull. (Part 2) 315, 318); Statement of the Managers on the Part of the House, H. Rep. No. 356, 69th Cong., 1st Sess., p. 30 (1939–1 Cum. Bull. (Part 2) 361); Regulations 86, Art. 115–1 to 115–9, Appendix, *infra*, pp. 16–18.

2. The action of the Circuit Court of Appeals, in deciding the case upon this alternative theory, involved no departure from the proper course of judicial procedure. It is clear that an appellate court may sustain the decision of a lower tribunal upon a different legal theory. *Bondholders' Committee* v. *Commissioner*, 315 U. S. 189, 192; *Le Tulle* v. *Scofield*, 308 U. S. 415, 421; *Helvering* v. *Gowran*, 302 U. S. 238, 245.[1] Although the question

[1] It may be observed that although the opinion of the District Court did not advert expressly to section 115 (g), it quoted (R. 64) from *Commissioner* v. *Champion*, 78 F. (2d) 513 (C. C. A. 6), which involved the application of section 115 (g). Moreover, the taxpayers' brief discussed cases involving section 115 (g) (Br. 27–29); and this section, to-

whether a distribution is "essentially equivalent to the distribution of a taxable dividend" has ordinarily been regarded as one of fact,[2] the Circuit Court of Appeals in reaching its decision here did not, as asserted by the taxpayers, make such a finding of fact. The court concluded that the evidence supported the District Court's finding that the distribution was a taxable dividend (R. 105). The District Court's determination that the transaction was not a partial liquidation, but a taxable dividend, necessarily embraced a determination that the distribution was "essentially equivalent to the distribution of a taxable dividend." The District Court said (R. 64–65):

> In the case at bar beyond the reduction in the number of shares of common stock and the transfer of $122,000 to surplus at the expense of the common stock account, nothing was done even remotely suggesting partial liquidation. But on the contrary this $122,000 was retained in the business actively working for twenty years helping produce the splendid earnings and constant annual dividend record as shown by defendant's Exhibit H, until 1934, the earn-

---

gether with the corresponding Treasury Regulations, was included in the statement of the relevant statutory provisions in the Appendix to the Government's brief (Br. 24, 27–28).

[2] See, *e. g.*, *Commissioner* v. *Babson*, 70 F. (2d) 304 (C. C. A. 7), certiorari denied, 293 U. S. 571; *Hirsch* v. *Commissioner*, 124 F. (2d) 24 (C. C. A. 9); *Hyman* v. *Helvering*, 71 F. (2d) 342 (App. D. C.), certiorari denied, 293 U. S. 570; cf. *Goldstein* v. *Commissioner*, 113 F. (2d) 363 (C. C. A. 7) (mixed question of law and fact).

> ings for that year alone being more than sufficient to pay $90,000 dividend plus the $122,000.

Obviously no purpose would have been served by sending the case back for a specific finding in the language of section 115 (g). Cf. *United States* v. *Wells*, 283 U. S. 102, 120. In the light of the facts specifically found, moreover, the conclusion that the distribution was "essentially equivalent to the distribution of a taxable dividend" followed by necessary implication, if not as a matter of law, and it was properly within the province of the appellate court to draw this conclusion. Cf. *United States* v. *Wells, supra;* see *Bogardus* v. *Commissioner*, 302 U. S. 34, 38–39; *Helvering* v. *Tex-Penn Co.*, 300 U. S. 481, 491.

3. There is no conflict between the decision below and the cases cited by the taxpayer: *Commissioner* v. *Brown*, 69 F. (2d) 602 (C. C. A. 7), certiorari denied, 293 U. S. 570; *Commissioner* v. *Rockwood*, 82 F. (2d) 359 (C. C. A. 7); *Commissioner* v. *Cordingley*, 78 F. (2d) 118 (C. C. A. 1); *Commissioner* v. *Quackenbos*, 78 F. (2d) 156 (C. C. A. 2); *Patty* v. *Helvering*, 98 F. (2d) 717 (C. C. A. 2). The question involved in these cases was whether a distribution made in cancellation or redemption of stock which has been issued as a stock dividend was taxable under section 115 (g). In none of these cases did the corporation have earnings at the time of the distribution, other than the earnings which had been capitalized upon the

issuance of the stock dividend. In these circumstances, the cases cited have held that section 115 (g) was not applicable where the original stock dividend had not been issued as part of a tax avoidance plan. But as the Circuit Court of Appeals made clear in *Patty* v. *Helvering, supra,* this rule has no application where, as in the instant case, a corporation has earnings at the time of the distribution upon which earnings section 115 (b) could take hold. The line of cases cited by taxpayer has recently been distinguished on this ground in *Flanagan* v. *Helvering,* 116 F. (2d) 937 (App. D. C.), which involved facts substantially similar to those at bar.

4. None of the remaining grounds advanced by the taxpayers in support of the petition requires more than passing consideration. *Dicta* in the opinion below on the question whether it is essential to a "partial liquidation" under section 115 (i) that a winding up of the business be contemplated, or that a policy of contraction be manifested (see Pet. 14–16), plainly afford no ground for review.

There is implicit in the decision below a determination that section 115 (g) is applicable to a distribution made during the taxable year, irrespective of the time the stock was cancelled. The taxpayers contend that in view of the express prohibitions against retroactivity contained in sections 201 (g) and 115 (g) of the 1926 and 1928 acts, respectively, an important question is pre-

sented (Pet. 13–14).[3] But the absence of a conflict is conceded. And there is no merit to the contention that the decision is erroneous for this reason, since the taxable event with which section 115 (g) is concerned is the *distribution*, and that took place within the tax years governed by the Revenue Act of 1934. The cancellation or redemption was not completed until that year.

The argument that the distribution in 1934 was made in payment of a "debt", owing from the corporation to its stockholders by reason of the reduction in stock (Pet. 16–17), was expressly rejected by the District Court (R. 65); patently such a characterization of the payment, even if it were correct, is not of significance in considering the application of section 115 (g). The question

---

[3] Section 201 (g) of the Revenue Act of 1926 and Section 115 (g) of the 1928 Act provide:

> In the case of the cancellation or redemption of stock not issued as a stock dividend this subsection shall apply only if the cancellation or redemption is made after January 1, 1926.

The purpose was to avoid retroactivity. S. Rep. No. 52, 69th Cong., 1st Sess., p. 15 (1939–1 Cum. Bull. (Part 2) 332, 344). Since the Revenue Act of 1932, this provision has no longer been contained in the statute. The committee reports accompanying the 1932 act stated that it was unnecessary since the income tax title of the act applied only to 1932 and subsequent years. H. Rep. No. 708, 72d Cong., 1st Sess., p. 22 (1939–1 Cum. Bull. (Part 2) 457, 473); S. Rep. No. 665, 72d Cong., 1st Sess., p. 31 (1939–1 Cum. Bull. (Part 2), 496, 518. Revenue Act of 1932, Sec. 1. Section 1 of the Revenue Act of 1934 provides that its income tax provisions "shall apply only to taxable years beginning after December 31, 1933."

under section 115 (g) does not turn upon the legal definition which might be given to the payment for cancellation or redemption in determining the rights of the parties *inter se,* but is solely whether the distribution was "essentially equivalent" to a taxable dividend. By the same token, there is plainly no occasion for review of the Circuit Court of Appeals' determination that there was no reversible error in the District Court's exclusion of evidence proffered to show an intention in 1914 supporting this theory of a "debt".

Also without substance is the contention that the distribution in 1934 was not a dividend because the capital reduction in 1941 gave Kiefer, as holder of all the preferred stock of the corporation, an enhanced right to share in the assets of the corporation upon liquidation (based on the claim that the preferred would participate share for share with the common) (Pet. 17–18). Equality of treatment among shareholders is not a prerequisite of a dividend. *Lincoln Nat. Bank* v. *Burnet,* 63 F. (2d) 131 (App. D. C.); *Hirsch* v. *Commissioner,* 124 F. 2d) 24, 29 (C. C. A. 9). And, in any event, the $122,000 distribution in 1934 was paid equally to the two principal stockholders of the Kiefer Company, according to their respective common-stock interests.

Finally, taxpayers make the contention (Pet. 20–22) (applicable only with respect to the taxpayer in No. 240) that the Court should review the

question whether a distribution to a trust, which would not be income as between life tenant and remainderman and hence not taxable to the life tenant, may be taxed as income to the trust. It is well settled, however, that it may. *Merchants' L. & T. Co.* v. *Smietanka,* 255 U. S. 509; *Burdick* v. *Commissioner,* 76 F. (2d) 672 (C. C. A. 3); S. M. 4241, IV–2 Cum. Bull. 191.

CONCLUSION

The decisions below are correct and present no conflict or other occasion for further review. It is therefore respectfully submitted that the petition for writs of certiorari should be denied.

CHARLES FAHY,
Solicitor General.

SAMUEL O, CLARK, Jr.,
Assistant Attorney General.

SEWALL KEY,
SAMUEL H. LEVY,
PAUL S. MCMAHON,
Special Assistants to the Attorney General.

AUGUST, 1942.